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KIDDIE TAX INCREASES TO EIGHTEEN

In a mostly surreptitious change to the tax law, the “kiddie tax” age under which a child’s unearned income is taxed at his or her parent’s rates has increased from the age of 14 to the age of 18. While this might seem quite unremarkable, it has various ramifications that might change your investment and estate planning behavior.

The “kiddie tax” law was enacted to prevent high income taxpayers from transferring income producing assets to their children and grandchildren, and as a result save on income taxes since the income was reported on the descendants’ tax returns at their lower rates, rather than at the higher rates of the parents.

The Congress caught onto this trick, passing legislation requiring any unearned income above \$1,700 at a child’s parent’s income tax rate as opposed to that child’s income tax rate. By enacting this legislation, it does not matter to the IRS whether interest and dividend income is reported on a child’s return or a parent’s return, as the marginal tax rate becomes the same.

Under the old law, it was assumed that upon attaining the age of 14, public policy would allow income to be taxed at the child’s lower rate. So savings for college education, for example, could accumulate at lower marginal income tax rates as the child approached college.

Fearing abuse under the law, a new law has been signed which expands the kiddie tax all the way up to a child’s eighteenth birthday. What does this mean for the average family?

- 529 College Savings accounts look better than ever. Under a 529 plan, the amounts accumulate income

tax deferred. Gains can be taxed free if amounts are withdrawn for qualifying educational expenses. Therefore a 529 plan will have much greater after tax returns than would a Uniform Transfer to Minors Act (UTMA) account or joint account with a parent/grandparent and child. Given the same before tax return, the UTMA account will be income taxed annually at the parent’s higher marginal rates, while a 529 plan may escape taxation altogether;

- Transferring family business interests or other income producing assets to children does not offer the income tax advantages that were once prevalent. Therefore, it is important to consider all relevant factors prior to making transfers of such income producing assets;

- Accumulation trusts (rather than mandatory income payout trusts) may become more popular. A common reason for not accumulating income within a trust for a child was that any income distributions could be taxed at the child’s lower marginal income tax rates to the extent that the income was actually distributed to the child. An accumulation trust, on the other hand, is taxed at higher collapsed rates. But if the marginal rate of the trust equals or is less than the parent’s marginal rate, so long as the child is under 18 and does not need the income for his or her needs, it may be beneficial to go ahead and accumulate the income and build the trust’s value.

Of course, there are many factors to consider in all of the above circumstances. Professional advice should be sought before making a decision on tax rates alone.

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